

Alternative market growth options for European Low Cost Carriers

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Abstract

In Europe, Low Cost Carriers (LCCs) emerged as a result of a liberalised European market and have enjoyed phenomenal growth, which has attracted a growing number of players into the market place. Increasing competition is leading to route saturation and overcapacity, which in turn show the way to price wars, shrinking margins, and eventually, consolidation. This paper examines the challenges faced by the European LCC sector today and the ways forward for LCCs.

Keywords: European Low-Cost Carriers; Market Growth Strategies; Consolidation; Ancillary products.

1. Introduction

The European low cost segment has experienced spectacular growth (averaging more than 30 per cent a year over the past five years), and while it is expected to continue to get bigger, the growth rate is likely to slow down as the market approaches saturation and overcapacity enters the system. UK has been the main focus of the low-fare carrier activity to date and is the largest and most mature market for LCCs in Europe. The dominant players in this market, Ryanair and EasyJet, account for almost 60 per cent of the “no frill” total and either is more than four times the size of any other participant (Association of European Airlines, 2006). Industry statistics (OAG, 2007) show that growth in the mature UK market has lowered to 14 per cent in the May 2006/07 period whilst the less explored markets of Spain and Germany had a 68 per cent and 52 per cent growth respectively.

In the advent of such statistics it would be an overstatement to talk about a crisis but it would still be true to state that competition is escalating and that the market cannot absorb all new entrants attracted to it during the growth phase of the LCC life cycle. As the sector heads towards maturity, a wave of consolidation is expected, as has occurred in the US where the low cost segment is now dominated by only three carriers, namely Southwest, Jet Blue and AirTran.

In the last years there has been extended academic literature on LCCs. Dennis (2007), Doganis (2005), Lawton and Solomko (2005) and Franke (2004) analyse LCCs' positioning in comparison to scheduled, network carriers, while Williams (2001), looks into competition issues between low-cost and charter airlines. Dennis (2005), Francis et al. (2003, 2004) and Franke (2007), investigate new areas for profitability for LCCs, whereas Mason (2001),

Barbot (2004) and Barrett (2004) examine the LCC-airports relationship, and Dobruszkes (2006) and Burghouwt et al. (2003) deal with the typology and geography of the routes network developed by European LCCs. The transformation and imminent consolidation of the European airline low-cost sector and the ways forward for LCCs are issues only partially addressed by academic articles to date. This paper aims at filling this gap. Our work is based on ample research from airline industry sources and academic literature, as well as interviews with industry experts.

2. Challenges faced by European Low-Cost Carriers today

2.1. Competition

Low Cost Airlines are facing a three-tier competitive front: other start-ups, offsprings from legacy carriers and charter airlines.

The reaction of legacy carriers started with indifference until the gradual realisation that the threat was here to stay. Some have set up a low-cost subsidiary and others are simply adjusting their fare policies to offer competitive prices in routes where they face competition from LCCs often with predatory pricing tactics (Morrison, 2004). LCC offshoot attempts include among others BA's low cost subsidiary Go (sold later to EasyJet), KLM's Buzz (acquired by Ryanair), SAS's Snowflake, BMI's bmibaby and Iberia's clickair. Many legacy carriers have now abandoned their LCC subsidiaries but have intensified their reaction to LCCs by imitating in their short haul intra-European flights major characteristics of the LCC model and reducing fare prices below the LCCs offer. The most extreme example is ex-national carrier Air Lingus who radically repositioned itself as a low-cost airline competing chest-to-chest with Ryanair. Network carriers will continue to adapt their strategies to competitively position themselves against erosion of their market share by LCCs. They are fairly well positioned to do so as their profitability relies mostly on business travel and long-haul traffic, allowing them to operate short-haul intra-European routes at a loss if they feel obliged to defend their market share.

The distinction between LCC and charters is also disappearing with charter airlines offering flights separately from their traditionally "packaged" product. EasyJet and Ryanair offer a number of routes to airports previously dominated by charter carriers (Malaga, Majorca, Ibiza, Alicante) and have taken significant market share from charter carriers but as low fares were already available in these markets there is less scope for growing total market size. Tour operators in markets such as Germany and the UK also adopt new business models to cope with LCCs. In the UK MyTravel set up its LCC subsidiary MyTravelLite and Thomson (part of TUI UK) introduced Thomsonfly. In Germany, Thomas Cook-owned Condor started competing with Air Berlin on the same routes until their merge was announced in September 2007.

Competition from charter carriers must be taken seriously as charters have several advantages: they sell a growing number of seats independent of tour packages with sales and distribution costs close to zero and their operating costs are equivalent to low-cost airlines' operating costs, partly due to even higher aircraft utilisation (with load factors of 95 per cent or higher).

2.2. Route saturation

One of the most critical challenges faced today by European LCCs is route saturation. Despite overall market growth, several low-cost market sources are now stagnating with LCCs withdrawing from many now saturated routes. Even leading low-cost player Ryanair had to seize numerous flights as a result of saturation (e.g. from Prestwick to Lubeck or from Shannon to Bournemouth, Lodz and Rome). High load factors are, a key element of the LCC model and only possible in routes that are not overly saturated. Demand can be stimulated with low fares up to a certain point beyond which load factors can only be secured at the expense of competitors.

The enlargement of the EU is providing LCCs with renewed market opportunities in deregulated Central and Eastern Europe. The question is whether new route development in non-saturated Southern and Eastern Europe will suffice to satisfy LCCs' need for growth. The UK market has been unique for the growth of LCCs, in that London is home to some 80 million passengers travelling to the rest of Europe (UK Civil Aviation Authority), who are high-income compared to travellers from South/East Europe and live on a rainy weather island with difficult access by car to warmer South Europe.

2.3. Overcapacity and consolidation

Despite increasingly fierce competition among legacy carriers, LCCs and charter airlines for the European skies, most operators continue to expand their fleet base. EasyJet announced in June 2007 that it is to add 35 new Airbus A319 aircraft during 2011 and 2012. Ryanair signed in May 2007 a deal with Boeing that will see it purchase 27 737-800 aircraft over the coming years. And Irish airline Aer Lingus has announced a major investment in its long-haul fleet as it looks to offer passengers new destinations and travel options and has confirmed an order for six A330-300E and six A350 XWB Airbus aircraft. Upcoming additional Available Seat Kilometres (ASKs) are unquestionably a challenge to the sector. With such a large number of new aircraft on order, the entrance of new LCCs in the market, rising competition amongst carriers and saturation of certain routes, many more markets will need to be developed to absorb upcoming aircraft capacity.

In a 2007 Delphi study of future trends in the EU airline sector (Mason and Alamdari, 2007) the consensus opinion of the industry experts was, amongst other, that network carrier consolidation will reduce EU players to less than five and that there will finally remain only two or three large low cost carriers.

Mounting competition has brought market leader Ryanair to warn in June 2007 that profit would rise just 5 per cent this year compared with growth of 42 per cent last year and CEO Michael O'Leary to state that "At this time with no visibility of winter bookings and yields, we believe that the company and our shareholders should remain cautious and conservative".

2.4. Other challenges faced by LCCs

LCCs are also subject to the usual airline industry difficulties such as:

- Cycle downturns. The airline industry faces risks that can negatively impact its forecast growth path, many of which (e.g. a global economic slowdown, security incidents, an avian flue pandemic) are beyond control. In general, air travel demand has proven to be resilient to exogenous disruption such as recession, war,

terrorism and disease. The impact of each crisis has lasted a relatively short time, after which strong growth has been resumed (after two years of stagnation following the September 11 attack, air travel demand increased 14 per cent in 2004, 7 per cent in 2005 and close to 6 per cent in 2006). Nevertheless, airlines must be able to survive during the critical times and in this sense some small-size LCC start-ups are worse positioned as their financial foundations are not as strong as those of established players.

- **Cost of Fuel.** Fuel prices are another critical economic factor affecting the industry. The price of standard crude oil on NUMEX was under \$25/barrel in September 2003, but by August, 2005, it had risen to over \$60/barrel, and out at a record price of \$125/barrel by May, 2008. Such oscillations have a considerable impact on a sector with about a third of the operating costs attributable to fuel.
- **Airport congestion and slots' shortage.** Apart from demand size limitations, route expansion is also limited by airport congestion and shortage in slots. As LCCs grow and target new segments (e.g. the business traveller, connection traffic passengers) they need more and more to use main European airports. Europe's main airports are congested and slots in many European airports are not easy to achieve (Forsyth, 2007). Also, in many cases (especially true in state-run airports) with the pretext of saturation in slot allocations, flag-carriers are protected. Airport congestion creates additional problems; long lines at security checkpoints and air traffic control delays. These issues will continue to trouble low-cost airlines for the indefinite future, as they are related to the issues of security, and overcrowding of the skies that will not disappear soon.
- **European Union Legislation.** Possible threats to LCCs also arise from the public administration area where European legislation for customer compensation, taxation for CO₂ gases, and new "State Aid" rules for publicly-owned airports increase aviation taxes and put pressure on LCCs' low fare offer.
- **Competition by rail.** An additional problem that European airlines will face, especially in the short-haul routes, is increasing competition from rail. Rail travel is unlikely to be impacted negatively by gas emission charges, further reducing the airlines' ability to compete on fare grounds. Eurostar, Germany's Deutsche Bahn AG and France's SNCF joined this year Dutch, Austrian, Swiss and Belgian train companies to form a rail alliance, Railteam, that aims to make international train bookings easier to attract at least 25 million travellers by 2010.

3. Alternative revenue growth areas

As competition intensifies and routes saturate, low-cost carriers must search and exploit new revenue streams to ensure profitability and continued growth. Opportunities from ancillary services or expansion to new segments such as long-haul travel or business passengers will form part of LCCs' growth strategies in the coming years and are analysed in the section below.

3.1. Search for non-saturated routes

In Europe, the LCCs' ticket revenue growth will ultimately depend on the number and size of new routes still to be opened, on an economic and sustainable basis. The accession of ten

new member countries to the EU in April 2004 automatically extended the territories and the number of airlines as a result of liberalisation. In these countries low wage costs, low incomes and weakness of the flag carriers are additional elements favouring the development of LCCs. Low-cost players are already taking positions with the two main carriers in the region, SkyEurope and Wizz Air experiencing considerable growth and Ryanair adding more and more Eastern European destinations.

3.2. Enter the long-haul market

We can segment the airline industry into four business models: short haul (where LCCs dominate); global and long-haul network (led by traditional carriers); charter and tour inclusive; and freight. At the current time, long-haul scheduled air services carry about one million passengers per week out of Europe on approximately five thousand flights. A boost is expected in the United States-Europe flights after their deregulation this year with the signature of the Open Skies Agreement (into effect since March 2008). Furthermore, the rapidly growing Middle-East and Asian markets also offer opportunities for long-haul route expansion and scheduled airlines are positioning themselves inaugurating new routes to these regions directly or through alliances.

Entering the long-haul segment with low-cost operations appears a natural development for LCCs. All the same, there are significant barriers to entry in the long-haul market, currently dominated and well protected by scheduled carriers and charters. Whereas in Europe, low-cost airlines have been able to more than halve the average fare paid per passenger, the best they are likely to achieve in long-haul markets is about 20 per cent off, and only by foregoing product features which are relatively more valued on longer journeys (Francis et al., 2007).

There are several reasons why it is more difficult to replicate the low-cost formula success in the long-haul market. First, traditional airlines in general already obtain maximum load-factors in long-haul flights, achieved in part due to the broad networks of scheduled carriers that allow connecting traffic. Second, there is a significant demand for business travel in their flights making the marginal cost of the economy class seats of a mixed configuration aircraft fall considerably. A low-cost model based on economy class only would be difficult to improve profitability. Moreover, international regulations do not permit the elimination of all frills and scheduled carriers already maximise aircraft utilisation as their machines operate 15-16 hours a day. Finally, due to the nature of long-haul flights it is not possible to eliminate overseas accommodation and allowances for staff, shrinking further the possibilities for LCC to achieve cost efficiencies and thus more competitive ticket prices.

Notwithstanding the challenge, leading European LCCs are envisaging expansion to the mid-, long-haul segments. Ryanair and easyJet have initiated flights to Morocco and the Middle East. Aer Lingus (already active in long-haul flights to North America) has announced a major investment in its long-haul fleet to match its growth ambitions in new routes to the U.S. following the Open Skies agreement. Ryanair's chief executive Michael O'Leary also announced that his company is planning to launch a new low-fare transatlantic airline that could allow passengers to fly to the U.S. for as little as 10 euros but went on to add that "this won't happen unless there's a cheap fleet" and that they "can't get rid of business class on long-haul flights because the economics of it don't add up."

3.3. Ancillary products

Revenues from non-ticket sources, which are called ancillary revenues, are becoming an important financial component for LCCs in Europe. From the moment of booking to the moment of arrival the passenger is a prospective customer for a broad range of products and services. Ancillary revenues can be defined as the à-la-carte services and products that passengers may buy in relation to their flight such as in-flight catering, checked-in luggage or advance seat allocation. Network carriers usually include these services in the price of an airline ticket. LCCs unbundle this package and offer passengers the option to purchase the different services separately upon an extra charge. Several airlines are making 10 to 15 per cent of their revenues on ancillary products and the list of such services grows longer every day. Ryanair's CEO has even stated that in the future profits from ancillary products and services will make charging for seats in his company unnecessary.

Moreover, ancillary services allow the airline to offer a wider range of services developed around the needs of the customer segment it wants to attract. This is becoming critical in the airline industry, where innovation and segmentation are today's strategy buzzwords. Below we list the ever growing list of non-ticket revenue sources.

- Other travel products. LCCs can sell other travel related services, such as hotel accommodations, car rentals, travel insurance, tickets to tourist attractions etc. through their own Web site and earn commissions on the sale. Revenue success will depend on the actual relationship with the travel partners (level of commissions) and the quality of their offer (variety, booking engine capability, quality of procurement etc.). The offer of additional travel products online not only offers an extra revenue stream but also provides an opportunity to improve the airline's Web site content and thus increase traffic.
- In-flight services. Services related to the in-flight experience are important not only for the revenue opportunity they entail but also for an airline's image. The list of in-flight services is broad and built up around in-flight entertainment (an expanding area covering movie and radio channels, newspapers and magazines, TV programmes, comics, games, on-screen gambling etc.), on-board merchandising, and on-board catering (where the passenger is really captive and likely to be in need of food and drink which he/she cannot get elsewhere during the flight).
- Advertising. A growing revenue source for LCCs is that of Internet and on-board advertising. Many low-fare airlines already have one of the top five or ten most-visited Web sites in their home markets. This makes them an easy and obvious source of click-through traffic generation for travel partners and other any other business who might be interested in advertising on their sites. Further advertising revenue opportunity comes from in-flight magazines, monitors, panelled tray-tables, overhead bins, annual reports, ground equipments and even the exterior of an aircraft.
- Frequent Flyer Programmes (FFPs) and Credit Cards. FFP miles or points are sold to banks issuing co-branded credit cards or to classic travel partners such as hotels and car rental companies. An additional revenue stream comes from FFP currency trading with non-air partners.

- Ticket related charges. Telephone bookings, changes in bookings, upgrades and even paper ticket if the passenger so prefers are all extra revenue sources. LCCs have also started charging for luggage check-in that translates not only in extra revenue but also into lower costs for check-in staff and baggage handling.
- Improved flight experience services. Priority boarding, seat assignment, seats with extra leg room, access to lounge services, access to parking, in-flight telephone and Internet access etc., are services many travellers are prepared to pay for and are particularly important to the business passenger.
- Business travel. Another revenue expansion area is that of targeting the higher yield business traveller who is in fact sought after by an increasing number of LCCs. About 20 per cent of easyJet's passengers are business travellers, a group it is actively courting. In order to attract the business segment, LCCs must provide next to low fares, business-friendly routes to main airports, high frequencies, access to lounges, flexibility to make changes, online check-in, generous hand-baggage allowances, speedy boarding, the option to change flights if necessary and a Frequent Flyer Programme.

Currently, LCCs mostly attract the “unmanaged business travel” portion of the market. The managed part of business travel which is the most lucrative in volume and yield is booked through Travel Management Companies using GDS technology to manage their customers' travel needs. This is one travel segment that will generally face challenges to book carriers which exclusively use a self-service, web-directed distribution strategy, meaning that LCCs must shift to indirect distribution strategies in order to attract this segment.

All the same, the International Air Transport Association (IATA) reported in September 2007 a 6.1 per cent year-to-date reduction of its members' (primarily major airlines) premium traffic in Europe. IATA attributed the reduction to “structural” rather than “cyclical” factors and added that there “is ongoing strong competition from no-frills airlines on European short-haul routes-even for business traffic” (IATA, 2007).

3.4. Connecting traffic

Connecting flights is a key feature of traditional carriers and their main competitive advantage. Network carriers (hence their name) are able to provide their customers a broad range of flight combinations within their own network or through alliances and code-share agreements with other airlines. Travellers naturally prefer point-to-point routes but no single airport can support daily frequencies to all different world destinations hence also the development of hub-and-spoke systems. As explained earlier, the LCC model is based on short-haul, point-to-point routes that allow several cost efficiencies. As a low-cost operator grows in destinations and frequencies on a pan-European basis the idea of combining an airline's own flights becomes attractive. As an example Air Berlin commenced in 2005 UK domestic services as feeders to its German services out of Stansted, introducing the network-model elements of through pricing, ticketing and baggage. Other European LCCs hardly offer the possibility to connect flights in order not to erode the LCC model that demands quick flight turnarounds and simplicity throughout the process but as routes begin to saturate, we expect to see more LCCs giving in to connecting traffic to fill in redundant aircraft space.

Another option to develop network traffic would be entering into code-sharing agreements with other airlines. For example Jetstar entered an agreement with Qantas to allow its flights

to be booked as a Qantas code-share to support inbound tourism in Australia. Many anticipate the possibility of European LCCs also acting as feeder airlines to the long-haul services of network carriers, but the experts in the Delphi study undertaken by Mason and Alamdari (2007) rule this out.

4. Conclusion

After a decade of rapid expansion and growth European low-cost carriers now face fierce competition on three fronts; new LCCs, charter airlines and traditional network carriers. Moreover, routes in Europe are starting to saturate, especially in the biggest markets (UK and Germany) and it remains to be seen if travel demand in the new areas of expansion (South and Eastern Europe) will suffice to meet current LCC capacity growth plans. Analysts and industry experts agree that the most likely scenario is that of consolidation.

LCCs can prepare for such consolidation by positioning themselves either as market leaders or as attractive acquisition targets. If a market leader strategy is chosen, it will be necessary not only to mark and defend a dominant territory but also continue to enlarge the business and outplay rivals.

Appealing opportunities for revenue growth exist in different areas such as expansion to non-saturated South/Eastern Europe, the offer of innovative and differentiating ancillary services, and the opening out to new segments such as long-haul travel or business passengers. All these levels of development are expected to form part of European LCCs' growth strategies in the coming years.

The question is whether Europe's low-cost operators will be able to maintain their cost advantages while expanding the business model to new innovative areas or to segments traditionally served by full-service carriers. First, many scheduled airlines are achieving important expenses' cut-backs and are narrowing the cost disadvantage gap. Second, expansion into more complex and demanding market segments such as business travel or connecting flights erodes the low-cost model and its cost differentials. The battle will finally be won by those carriers who balance best adapting to the new reality whilst maintaining their original cost-advantages through austere cost control.

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